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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 202

EUTERPE ECONOMOS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 1-4) [1] is not reported. The opinion of the Court of Appeals (R. 32-35) is reported at 167 F. 2d 165.

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[1] The record citations herein designated "R" refer to the portions of the Transcript of Record. Those designated "Tr" refer to the unprinted portion of the record as certified to the court by the Clerk of the Court of Appeals for the Fourth Circuit.

JURISDICTION

The judgment of the Court of Appeals (R. 36) was entered on April 2, 1948. A petition for rehearing was denied on May 7, 1948. (R. 49.) The petition for a writ of certiorari was filed on August 6, 1948. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

The taxpayer, sole owner and operator of a restaurant, made a gift in trust to each of her two minor children of a one-fourth interest in the restaurant business, and simultaneously entered into a partnership agreement with the trustee under the trusts. The taxpayer continued to run the business as before; the children contributed no new capital, and neither they nor the trustee performed any vital services or participated in management.

The question presented is whether the courts below erred in sustaining the Commissioner's determination that, for Federal income tax purposes, the donor's children were not to be treated as partners, and hence that the shares of the business income attributed to the children were includible in the taxpayer's gross income.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 22 [as amended by the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1]. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing) of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * [26 U.S.C. 22.]

STATEMENT

The facts as found by the Tax Court (R. 1-3) are as follows:

The taxpayer and her husband conducted the business of Chamberlin Cafeteria at 819 15th Street N. W., Washington, D. C., as equal partners prior to his death in 1937. (R. 1.)

They had two children, a daughter born June 12, 1926, and a son born July 20, 1928. (R. 1.)

The husband died intestate and the taxpayer inherited one-third of his one-half interest. She paid $7,500 to his estate for the other two-thirds representing the part of the father's estate to which the two children were entitled. (R. 1.)

The taxpayer has conducted the business alone since the death of her husband. She had had training and experience in the restaurant business and has been successful in operating Chamberlin Cafeteria. (R. 1.)

The children were in boarding schools during the taxable years 1941 and 1943. They sometimes helped at the cafeteria during vacations but neither rendered any vital services or took any part in managing the business during those years. (R. 1.)

On January 2, 1941, the taxpayer created two trusts (R. 6-8) one for each minor child. She named her sister trustee of each trust. The trust deeds recited that the taxpayer conveyed a one-fourth undivided interest in the restaurant business in trust for the child until the child attained the age of 23 in the case of the daughter and 21 in the case of the son, at which time the beneficiary was to receive the interest free of the trust. The trustee had no authority to use any income except to pay the expenses of the trusts. The trusts were irrevocable and the corpus could not revert to the taxpayer. (R. 1-2.)

The taxpayer and the trustee, on the same day, entered into an agreement (R. 9-12) that they were to conduct the Chamberlin Cafeteria as partners for ten years, using the interests contributed by each. The agreement recited that "The first party hereby assigns to the second party, as trustee, as aforesaid, an undivided equal one-half part of the gross assets described in 'Exhibit A' as belonging to her for the purpose above indicated." Additional capital needed was to be contributed equally. The taxpayer was to devote her full time to the business. The trustee was not obligated to devote any of her time to the business. She lived and had full time employment in Boston, Massachusetts, and devoted none of her time to the business of Chamberlin Cafeteria. The net profits or losses were to be divided equally at the end of each year and credited to the proper accounts. The parties had the right to withdraw their profits "in such amounts and at such times as the parties may mutually determine." (R. 2.)

The balance sheet of December 31, 1940, showed the net worth of the business as $22,099.35. (R. 2.)

The taxpayer filed gift tax returns showing a gift of one-fourth interest in the business to each child at values of $10,500 each. (R. 2.)

The capital account of the trust for the daughter on the books of the business is as follows (R. 3):

Balance—Capital Account January 1, 1941		$5,524.84
Add: Share of Earnings—year ended December 31, 1941		5,839.67
		11,364.51
Less: Drawings—year ended December 31, 1941:		
Share of 1940 Excise Tax Paid	$30.42	
Guardianship Expenses	16.40	
Insurance	11.70	
		58.52
Balance—December 31, 1941		11,305.99
Add: Share of Earnings—year ended December 31, 1942		10,012.30
		21,318.29
Less: Drawings—year ended December 31, 1942		
War Bonds Purchased	$258.75	
Income Taxes	633.24	
		891.99
Balance—December 31, 1942		20,426.30
Add: Share of Earnings—year ended December 31, 1943		12,885.65
		33,311.95
Less: Drawings—year ended December 31, 1943:		
Federal Income Taxes	$5,849.23	
D. C. Income Taxes	110.18	
War Bonds	750.00	
		6,709.41
Balance—Capital Account—December 31, 1943		26,602.54

The account of the trust for the son is almost identical. (R. 3.)

No trust income was used to support or maintain the children. (R. 3.)

The Commissioner, in determining the deficiencies, included the entire income of the restaurant business in the income of the taxpayer on the ground that the partnership was not to be recognized for Federal income tax purposes and the income was taxable to her under Section 22 (a). (R. 3.)

The Tax Court sustained the action of the Commissioner (R. 4), and the Circuit Court of Appeals affirmed. (R. 32-35.)

ARGUMENT

This case is in all respects controlled by *Commissioner* v. *Tower*, 327 U. S. 280, and *Lusthaus* v. *Commissioner*, 327 U. S. 293. The decision also accords with a large number of cases in the Circuit Courts of Appeals and the Tax Court.

The case presents the rather common factual situation of a sole proprietorship, owned, operated, and controlled by the taxpayer, which is converted into a "partnership" by the use of a trust instrument conveying a one-fourth interest to each of the taxpayer's two minor children. No vital services were contributed to the alleged partnership by the trustee or the children and no capital not previously owned by the taxpayer was contributed by the trustee or the children. The business continued to be operated and controlled after the formation of the partnership in the same old way.

The earnings of the business remained on hand and available for use within the business. The trustee had no authority to withdraw income except at such times as the taxpayer and the trustee mutually agreed upon. (R. 2.) Except for the payment of taxes, only $1,000 for the purchase of war bonds for each child was withdrawn during the three year period involved; the share of the net earnings for each was in excess of $22,000. (R. 3, Tr. 40, 41.) During the same period, the taxpayer withdrew some $32,000 of about $57,000 available to her before taxes were paid. (Tr. 39.)

In the *Tower* and *Lusthaus* cases, *supra*, this Court indicated that the decisive question in such cases is not who may own a share of the capital but who produced the income. Those cases hold that family partnerships, based upon gifts of business capital, though valid and enforceable under State law, are without Federal income tax significance if the arrangement produces no substantial change in the production of the business income but merely represents a reallocation of such income within the family group. Unless the donee "invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the conclusion is justified that the donee is not a real partner for tax purposes. The Tax Court and

the Circuit Court of Appeals below so held in the factual context of this case.

The taxpayer attempts to avoid the *Tower* and *Lusthaus* cases by suggesting that a gift in trust of a portion of a business, in which capital is a material income-producing factor, differs from an absolute gift of such an interest for the reason that the trust must be recognized as a separate taxable entity. Since a gift directly to the children would not accomplish the result sought by the taxpayer, the mere creation of a trust certainly cannot accomplish that result. To permit the tax consequences here to turn upon the considerations stressed by the taxpayer would sanction the very type of formalism which this Court and the Circuit Courts of Appeals have repeatedly refused to recognize as effectual to alter tax liability. *Belcher* v. *Commissioner,* 162 F. 2d 974 (C.C.A. 5th), certiorari denied, 332 U. S. 824; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C.C.A. 3d), certiorari denied, 332 U. S. 767; *Hash* v. *Commissioner,* 152 F. 2d 722 (C.C.A. 4th), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Dawson v. Commissioner,* 163 F. 2d 664 (C.C.A. 6th); *Benson* v. *Commissioner,* 161 F. 2d 821 (C.C.A. 5th); *Losh* v. *Commissioner,* 145 F. 2d 456 (C.C.A. 10th).

Nor is there merit in the taxpayer's argument (Pet. 9-11) that the decision below is in conflict with the decision of the Circuit Court of Appeals

for the Tenth Circuit in *Armstrong* v. *Commissioner,* 143 F. 2d 700. That case, like this one, turned on its own facts; and the case, which antedated the *Tower* and *Lusthaus* rulings, has apparently been strictly limited to its precise facts by the court which decided it. Cf. *Losh* v. *Commissioner, supra.*

The taxpayer's suggestion of a conflict between the decision below and *Poe* v. *Seaborn,* 282 U. S. 101, is also insubstantial. The *Seaborn* case held that Congress had not intended to tax to one spouse his entire income in states in which community property laws gave to the other a vested one-half interest. The considerations underlying that decision are inapposite here.

CONCLUSION

The decision below is correct. There is no conflict of decisions and the case does not warrant further review. The petition should be denied.

Respectfully submitted,

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SEPTEMBER, 1948.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1948 803726